A Home Price Firewall

By Martin Feldstein
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Home prices are down 20 percent from their peak in 2006 and are falling rapidly across the country. Experts predict an additional 15 percent decline during the coming year as the housing price bubble is undone.

The danger is that home prices could spiral further down, hurting millions of homeowners and pushing the economy into a deep recession. Nearly 10 million Americans, about one-fifth of all homeowners with mortgages, already have mortgage debts that exceed the value of their homes. As prices fall, that number could double during the coming year. Many people would have mortgages that exceed their home's value by 20 to 50 percent.

Mortgages are generally no-recourse loans, meaning creditors can take the house of someone who stops paying his or her mortgage but cannot seize other assets or wages. Individuals with negative equity therefore have an incentive to default because the home that they give up is worth less than their mortgage debt. Mortgage defaults and foreclosures hit a 30-year high in the first quarter of this year. As the gap between mortgage amounts and home values widens, that incentive to default will become stronger.

Widespread defaults and the resulting foreclosures could also generate a downward spiral in home prices. It is impossible to know where such a self-reinforcing process would stop.

I believe the federal government should create a firewall to prevent too great a fall in housing prices. It is important to go beyond the legislation that is about to be enacted by the Senate, which would help some homeowners who have negative equity but would not do anything to forestall the growth of this problem. This can best be done through a program of mortgage replacement loans.

Such a program might be structured this way: The federal government would offer all homeowners with mortgages the opportunity to replace one-fifth of their existing mortgage (up to some dollar limit) with a government loan. This loan would carry a substantially lower interest rate than the individual's mortgage (reflecting the government's cost of funds). It would be a full-recourse loan that would have to be repaid regardless of what happens to the borrower's mortgage or home. By law, it would take priority over all non-mortgage debt.

Such a mortgage replacement loan would eliminate the potential incentive to default for almost all homeowners who now have positive equity. In doing so, it would limit the number of foreclosures that could contribute to a downward spiral.

Consider how the program would work for someone who has a $360,000 mortgage on a home worth $400,000, a 90 percent loan-to-value ratio. A 15 percent drop in prices would push that homeowner into a negative equity position, because the house's value would be only $340,000. But if one-fifth of that $360,000 mortgage ($72,000) were converted to a loan from the government, the mortgage loan be $288,000. As a result, the 15 percent decline in housing prices would still leave the homeowner with $52,000 in positive equity -- the difference between the reduced house price of $340,000 and the new mortgage of $288,000. There would be a strong reason not to default.

A program of mortgage replacement loans would act as a circuit breaker to reduce the number of defaults that would otherwise occur as the housing bubble inevitably deflates. In doing so, it would stop prices from overshooting on the way down in the same way they did on the way up.

Because this program would, in effect, swap government bonds for individual IOUs, it would not involve any increase in government spending or in the deficit. Because the loans would appeal primarily to those who now have positive equity in their homes, it would not reward people who made high-risk purchases and now have high negative equity. By lowering the interest rate on one-fifth of their mortgages, it would help participants meet their monthly payments. And the substitution of government bonds for a portion of outstanding loans would provide substantial liquidity in the credit market, which could be used to support new lending.

Yet all these advantages would be incidental to the primary purpose of the mortgage replacement loans: reducing the amount of non-recourse mortgage debt and therefore reducing the risk of a damaging downward spiral in home prices and the economy. Congress needs to act quickly: Home prices fall every week, increasing the number of homeowners who have negative equity -- and an incentive to default.

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